Are we witnessing the last gasps of globalization?

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Globalization shrunk the world. Free trade in products and services, unencumbered movement of people, ideas and capital, open capital markets, production and technological inventions, public support for global trade, and adherence to international law reached record levels. The world economy and stock markets thrived.

By displacing expensive workers in developed countries with the cheaper labour force of China and India, the increased pool of labour drove wages down, or prevented them from rising in Western economies, thus keeping inflation low. While manufacturing jobs disappeared at an alarming rate, service jobs increased. The difference between financial services compensation, for example, and manufacturing wages skyrocketed in Canada, Britain and France, and flattened out or declined in China and India.

What is most disconcerting is that the last time we witnessed such a run-up in the difference between financial services and manufacturing compensation was in the 1914-30 period – which began with the demise of an earlier era of globalization and ended with the stock market crash and the Great Depression.

Wars tend to lead to an end of, or challenges to, globalization. The wave of globalization in the 19th century, ending by the time the First World War broke out, was followed by protectionism and instability. There were efforts to improve economic co-operation after the Second World War with institutions such as the International Monetary Fund and World Bank, but the absence of the Soviet Union as a member of those institutions made globalization and economic co-operation difficult.

Fast-forward several decades: The fall of the Berlin Wall, the break-up of the Soviet Union and the end of the Cold War in 1989-91 ushered in the new era of globalization. The admission of China to the World Trade Organization in 2001 completed the picture.

But, as early as 2007-08, concerns started to arise in the United States when critical industries such as semiconductors, artificial intelligence and other sensitive high tech fields made dependence on foreign producers a high security risk.

As a result, as early as 2008 companies started to gradually transition toward more local production, with U.S. exports falling as a share of GDP. Trade data between 2008 and 2020 show that exports (goods only) declined on average by 0.1 per cent per annum as opposed to an average 7.4-per-cent increase per annum between 1991 and 2007. The trend accelerated during the pandemic owing to significant supply chain problems. Companies have now started to place higher importance on having goods for manufacturing and distribution close by. The invasion of Ukraine by Russia will intensify the trend.

The surge of new manufacturing in North America is increasing the demand for labour, and since there are not enough workers around to fill the jobs, wages are rising. In December, 2021, there were 11.4 million unfilled jobs in the U.S. according to the Bureau of Labour Statistics. Moreover, in his recent State of the Union speech, President Joe Biden called on U.S. businesses to bring even more production back home. At the same time, China, Russia and India are challenging globalization.

In my opinion, the secular trend toward globalization has now ended. Notice the similarities with previous end-of-era periods of globalization: a pandemic that has been likened to a war, challenges to globalization by large players such as Russia and China, and rising protectionism, economic instability, and galloping inflation.

Deglobalization (with events in Ukraine auguring a new Cold War) and resultant rising inflation and increasing real interest rates create a bleak outlook for the stock, bond and real estate markets. The outlook appears particularly unfavourable for growth stocks, which will be hurt the most by deglobalization and inflation. Their underperformance will also have an adverse effect on the whole market as the share of the technology sector in market indexes has increased steeply in recent years.

Moreover, during the Cold War years between 1966 and 1991 – with U.S. inflation averaging 4.3 per cent annually – value stocks outperformed growth stocks by 10.8 per cent per annum, whereas between 2008 and 2020 – when inflation averaged only 1.7 per cent – growth outperformed value by 4.2 per cent.

The U.S. Federal Reserve may not be able to help this time, as it will be facing a Catch-22. The ballooning debt issuance around the world (including margin debt) in recent years have made economies and financial markets very sensitive to interest rate increases. Between 1991 and 2007, U.S. debt-to-GDP averaged 60.3 per cent while between January, 2008, and February, 2020, it averaged 98.8 per cent and between March, 2020, and December, 2021, 126.5 per cent. The Fed may abandon the inflation mandate to support the financial system as it has done in the past, but given the amount of debt outstanding in the face of the structural changes referred to above, this may lead to financial markets and the economy falling too quickly to bail out.

The markets have yet to discount this outlook.

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